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northwest economic
indicators

NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS AN AFFILIATE OF NORTHWEST BANCORPORATION

U.S. Agriculture in the Eighties

August 21, 1980

Highlights

- **World population trends suggest continuing strong demand for food. Oil-price increases, inflation and a slowdown in world economic growth, however, will put a lid on potential demand in the next few years.**
- **By the mid-1980s, world demand for agricultural products will be on a strong upward trend. The United States will be in a good position to capture a large share of this increase.**
- **Although demand for agricultural output will in general press against productive capacity, favorable net returns for farmers are not guaranteed. Farm margins will continue to be squeezed by rising input costs. To cope, farmers will need to adopt cost-savings technology, spread farm machinery costs over larger numbers of acres and carefully plan their marketing strategies.**
- **The grain reserve will tend to place a ceiling and floor on crop prices, however, considerable volatility will exist since the United States will continue to be a residual supplier of food to the world.**
- **The cattle cycle has entered the rebuilding stage. The next few years should be profitable for both cattle ranchers and beef feedlots. By the mid-1980s, livestock numbers will again reach record levels in the United States, resulting in strong domestic demand for feed grains. Beef processors will benefit from increased volumes.**
- **Recovery in farm income will cause a strong rebound in farm machinery and equipment sales across a broad range of products. Farm consolidation suggests that the trend toward larger, more productive machinery will continue.**

Dr. Sung Won Son
Senior Vice President and
Chief Economist

The huge swings in agricultural commodity prices during the past seven months dramatize the volatile nature of American agriculture. Earlier this year farmers had to contend with weak demand for farm products, surging farm production costs and plummeting farm income.

Fortunately, agricultural conditions have changed significantly since this past spring. Aided by a heat wave which settled in the southern portion of the nation, farm prices rose dramatically during July. Although prices may ease as crop prospects become more certain, recent increases in loan rates and related release levels for the grain reserve will limit the possible decline. Accordingly, farm income prospects have improved substantially.

Of course, there still are the "haves" and "haves nots" depending on whether individual farmers were spared the extreme drought conditions. Overall, however, agriculture appears to be on the road to recovery. What is in store for the rest of the decade? What obstacles lie around the bend? How prosperous will agriculture be?

Demand For Food

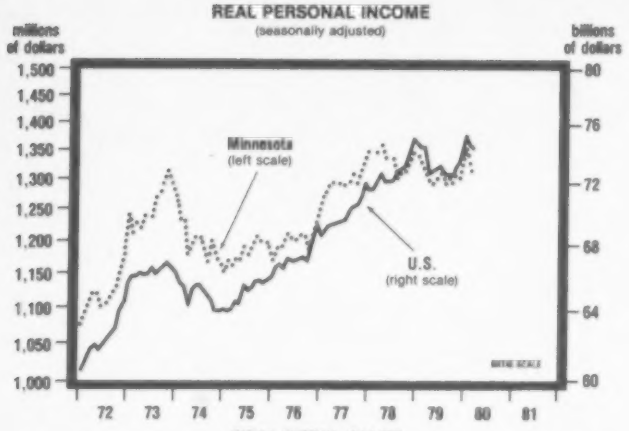
Rising population, income growth and related efforts to upgrade diets are the major factors behind the long-run growth in world demand for food. Demand for food grains is particularly responsive to population growth in developing countries, while demand for meat and consequently demand for feed grains is more directly related to income prospects in developed countries.

According to the U.S. Census Bureau's Series II medium population projections, total world population is expected to reach 5.34 billion by 1990, up nearly 900 million from 1980, with the vast bulk of this growth occurring in the developing countries. Such population growth suggests continuing strong demand for food, however, the level of income will put a lid on potential demand at least in the next few years. Those developing countries that must import petroleum are experiencing balance of payments difficulties. At the same time, inflation and an economic downturn will limit income gains in the industrialized countries. Partially offsetting this will be increased demand by the oil-rich countries and the high-income developing countries such as Taiwan, South Korea and Hong Kong.

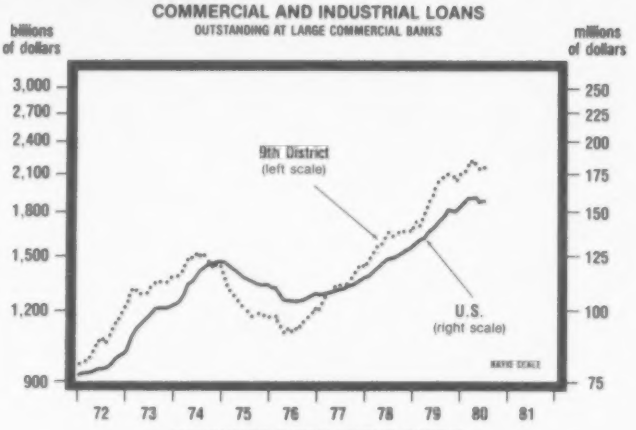
The greatest uncertainty and, at the same time, the largest potential for expansion in world food demand lies in the centrally planned countries. Agricultural production in countries such as the Soviet Union and China will not keep up with long-term food needs. Although the demand for U.S. products will be hampered by the desire to avoid high dependence on the United States, our exports to the centrally planned countries will expand. Trading relations with the Soviets probably will be normalized in the

REGIONAL ECONOMIC CONDITIONS

REAL PERSONAL INCOME
(seasonally adjusted)

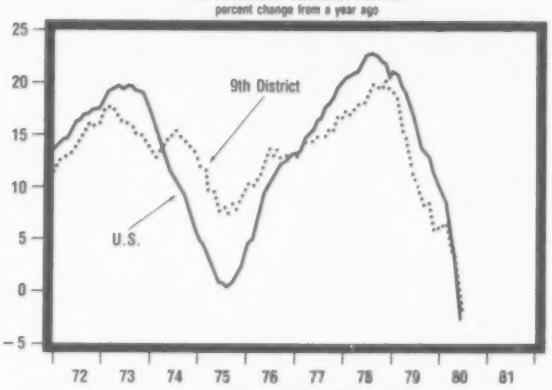


COMMERCIAL AND INDUSTRIAL LOANS
OUTSTANDING AT LARGE COMMERCIAL BANKS

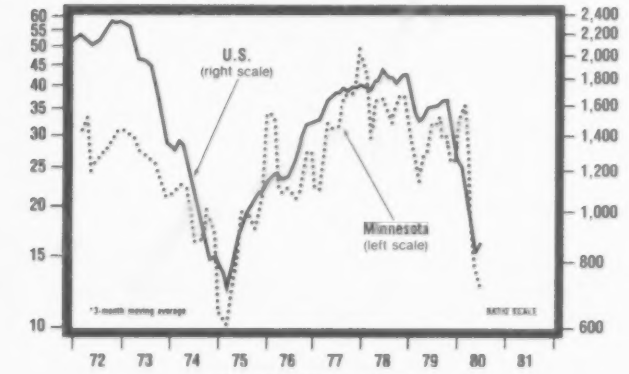


REAL RETAIL SALES
(seasonally adjusted)

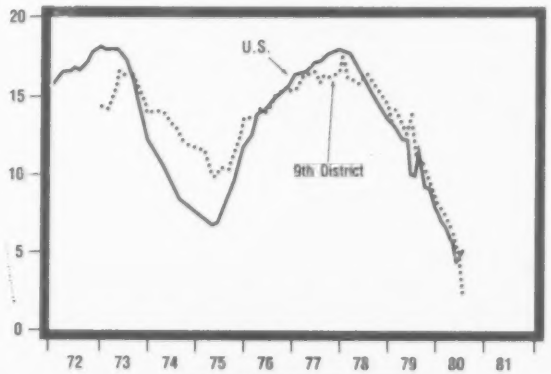
CONSUMER INSTALLMENT CREDIT
OUTSTANDING AT COMMERCIAL BANKS
percent change from a year ago



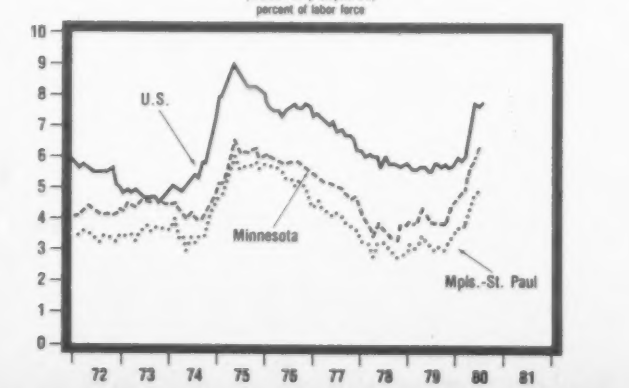
HOUSING UNITS AUTHORIZED
HOUSING UNITS AUTHORIZED BY BUILDING PERMITS
(seasonally adjusted annual rates*)
thousands of units



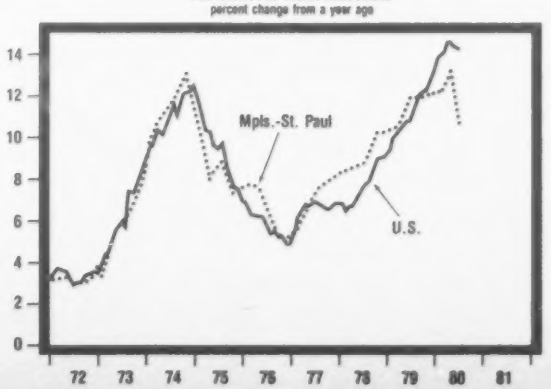
MORTGAGE LOANS
OUTSTANDING AT SAVINGS AND LOAN ASSOCIATIONS
percent change from a year ago



UNEMPLOYMENT RATES
(seasonally adjusted)
percent of labor force



CONSUMER PRICE INDEX
ALL ITEMS, ALL URBAN CONSUMERS
percent change from a year ago



early 1980s. Due to erratic Soviet grain production, however, variability will continue to characterize these trading relations.

Although domestic food demand will also expand, U.S. agriculture will become increasingly dependent on international markets for its well-being. As the decade progresses, world economic recovery and continued population growth will stimulate demand for food. By the mid-1980s, world demand for grains, oilseeds, fiber and livestock products will be on a strong upward trend. The United States will be in a position to capture a large share of this increase. Thus growing farm exports will fuel the boom in total sales of farm products.

Crops

The growth in demand for agricultural output in the 1980s, though slower than the 1960s and early 1970s, will in general press against productive capacity. To be sure, periods of excess supply may still emerge. For example, such a situation could arise if back-to-back abundant Soviet grain harvests occurred simultaneously with favorable U.S. crop production.

Unfortunately, the prospect of crop production running close to full capacity does not necessarily mean that farmers will be guaranteed favorable net returns in the 1980s. Farm margins will continue to be squeezed by rising input costs such as fuel and fertilizer.

The successful operator will be one who adopts cost-saving technology, spreads farm machinery costs over larger numbers of acres, increases crop yields through use of agricultural chemicals and new varieties of seed, and adopts a well thought out crop marketing program.

There will be increased economic incentives to adopt energy-efficient systems of production. Even greater stress will be placed on minimum tillage combined with increased use of chemicals for weed control. The relative competitive position of those regions dependent on irrigation will tend to diminish. New methods of irrigation will be adopted to mitigate the effects of higher energy costs and limited supplies of water.

Transportation problems and wide regional variations in grain prices will continue during the eighties. While approval has finally been given to proceed with improving Locks and Dam 26 at Alton, Illinois, completion is expected to take up to 10 years. Meanwhile, farming regions served by the Upper Mississippi will have to utilize more expensive modes of transportation to export markets. There will be increased incentives to market grain through elevators which obtain or maintain access to unit trains.

The Food and Agricultural Act of 1977, the basis for current farm programs, will expire in 1981. The upward push in farm input prices will be translated into political pressure to develop a formula for increasing loan rates and target prices more rapidly in the 1980s than was the case in the late 1970s. In general terms, however, the eighties will bring only marginal changes in farm legislation.

For exportable commodities such as grains, soybeans and cotton, government loan rates will tend to be set slightly below the longrun world equilibrium price trend. This will facilitate the export of farm commodities while at the same time providing some price protection for a highly cyclical industry.

The farmer-owned grain reserve will remain a fundamental part of agricultural policy and may be expanded during the 1980s. The grain reserve will be relied upon to prevent large price declines during periods of excess supply as well as rapid escalation in times of crop shortfalls. Although the grain reserve will tend to place a ceiling and floor on crop prices, commodity prices still will exhibit a fair degree of volatility since the United States will continue to be a residual supplier of food to the world.

No major changes are anticipated in farm structure during the 1980s other than those implicit in the trends that have prevailed over the past several decades. Although public debate is likely to focus on the trend toward larger farms and the separation of ownership and use of farmland and other agricultural resources, the trend toward fewer and larger farms and the increasing importance of capital in agriculture will continue.

Wheat: The projected population growth and rising living standards in developing countries bode well for long-term demand for wheat. The gap between foreign production and consumption will continue to widen in the 1980s. In the next few years, however, balance of payments pressures in oil importing developing countries will dampen export growth. Thus the extend of food assistance will influence the growth of U.S. wheat exports in the early 1980s. As the decade progresses, wheat exports are expected to rise fairly rapidly leading to an upward trend in wheat prices.

Corn: Inventories and prices of corn are directly influenced by the U.S. livestock industry which utilizes around 75 percent of our corn production. During the next year, domestic utilization will slow in response to reduced livestock production. Export demand will also be sluggish, reflecting slower economic growth in the industrialized countries.

In a few years, however, demand for feed grains will be on a strong upward trend. On the domestic side, a major expansion in livestock feeding is anticipated with total grain consuming animals reaching record levels by the mid-1980s. The use of corn in the production of gasohol will also increase. Nevertheless, at least during the early part of the decade, it seems unlikely that gasohol will account for a very significant portion of U.S. grain production. Growing domestic utilization of corn will be joined by strong export demand as the industrialized countries recover from the current economic slowdown. Thus, an upward trend is expected in corn prices and acreage during the 1980s.

Soybeans: The anticipated expansion of livestock feeding in the United State will provide an expanded market for soybeans in the 1980s. Export opportunities will also continue to grow. However, due to increased world competition and competition from alternative oil sources, U.S. soybean exports will not expand as rapidly as in the 1970s. Consequently, soybean prices are not expected to rise as rapidly as in the past decade.

The Soviet Union provides a potentially growing market for soybeans. Currently, the Soviet Union accounts for about 15 percent of the world's grain usage but only eight percent of oilseed use. Increased usage of protein meal would yield more efficient feeding rations for the Soviet livestock industry. In order to stretch their feed supplies during the U.S. grain embargo, the Soviets have already increased their purchases of soybean meal processed in western Europe.

Livestock

Beef: The largest liquidation of beef cattle in history has ended. The rebuilding phase of the cattle cycle is expected to start in earnest in 1981, with cattle numbers continuing to rise until at least 1986, a longer rebuilding phase than normal. Even so, the next peak in cattle numbers may not reach the previous peak level.

Drought conditions could slow the build-up in the beef herd. In addition, the high cost of re-entering the cattle industry will make south-eastern producers reluctant to get back into the business. Nevertheless, the July 1 USDA cattle inventory report confirmed that the cattle cycle is indeed turning. The early years of this expansion phase should be profitable for both the cow-calf operator and the cattle feeding business.

Relatively low grain prices in the western portion of the corn belt will tend to counteract the climatic advantages, and hence lower fixed costs, enjoyed by the large commercial feedlots in the southwest. As a result, specialized feedlots in the western corn belt region may grow in importance during the 1980s.

Hogs: Although the increase in confinement feeding along with higher capital investment costs will dampen the fluctuations, the hog cycle will still be part of agriculture in the 1980s. Recently depressed hog prices will result in a liquidation of hogs during the next couple of years, with the rebuilding phase starting by 1982.

Due to relatively low feed grain prices, hog production will increase in importance in the western portion of the corn belt. Studies have shown that over a five to ten year period, corn belt hog farms have experienced higher returns to investment than any other major farm operation. Diversification into livestock production may become essential for the beginning farmer.

Agri-Business

Given the trends discussed earlier, how will the suppliers of agricultural inputs and the processors and distributors of agricultural goods fare in the 1980s?

Input Suppliers: Farm machinery sales are closely tied to changes in farm income. The recent increases in farm prices and the anticipated significant recovery in farm income is expected to result in a strong rebound in farm machinery and equipment purchases during the next couple of years. Part of this strong demand will arise from a bunching of purchases which were postponed earlier this year.

Continued farm consolidation suggests that the trend towards larger, more productive machinery will continue. This allows farmers to plant and harvest crops rapidly, shortening the period of good weather required for these operations.

In the recent past, farm machinery sales have been the strongest for the largest size units such as four wheel drive tractors. Sales have also been heavily weighted towards the wheat belt. An improvement in corn and soybean prices relative to wheat could stimulate demand across a broad range of products, particularly in the corn belt.

Strong demand is also expected for fertilizer and other agricultural chemicals. In general, emphasis will be given to those farm inputs or technologies which either reduce production costs or increase yields.

Commodity Processors: From the standpoint of supply, the operating environment for beef processors will improve as the rebuilding stage of the cattle cycle picks up momentum. Slaughter volume will again reach high levels by the mid-1980s. Industry concentration levels are likely to increase. In addition, due to advantages in transportation and more efficient use of labor, more beef will be pre-cut at packing plants.

During the next couple of years, pork processors will be faced with declining slaughter volumes and higher prices as hog production declines from current peak levels. This situation will be reversed again as hog production reaches another peak around 1985.

Although not matching the growth experienced in the last five years, continued growth is expected in the broiler industry. Both the broiler and turkey industries will focus on further processing of products.

For non-livestock processors, sales and profits will be tied closely to the price and availability of raw materials. A substantial rise in world sugar prices during the past year, has been a big plus for the corn sweetner industry. During the next few years the industry is expected to continue to benefit from higher sugar prices. Thus, despite the recent increase in corn prices, margins are expected to remain favorable.

Expansion of production facilities could eventually put the industry into overcapacity, especially as world sugar production starts to increase again. However, additional substitution of high fructose corn syrup in soft drinks could lead to continued strong demand. In addition, increased fuel alcohol capacity could benefit the corn processing industry by providing a contra-seasonal demand to the sweeteners used extensively in canning and soft drinks.

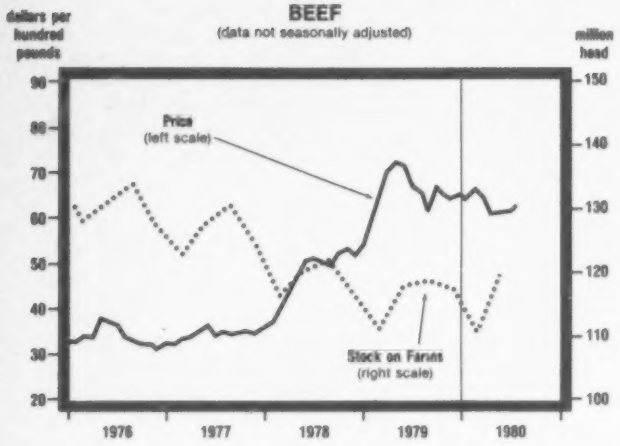
Soybean processors are expected to experience continued growth in demand during the 1980s. At the same time the domestic market for sunflower oil will expand, stimulating the construction of additional processing plants in the United States.

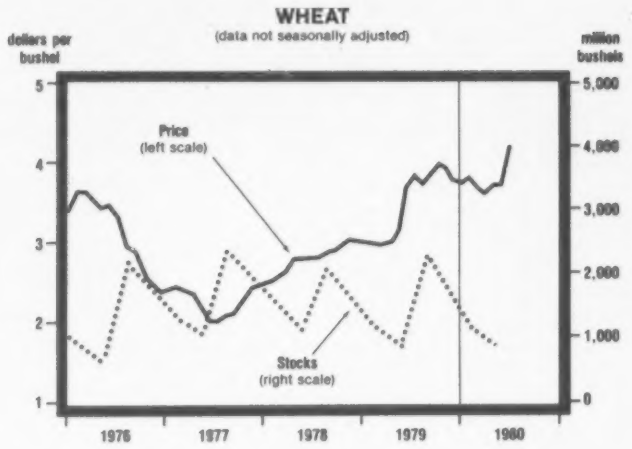
Grain Merchandising: World economic conditions may slow the growth of export demand during the next year. However, the longer-term outlook is for continued strong growth of grain and soybean exports.

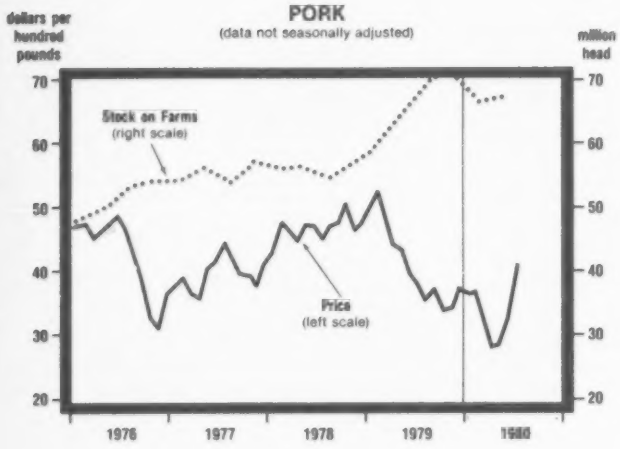
Our exports will continue to be subject to the vagaries of weather and government policy. Since the United States is essentially a residual supplier in the world markets, commodity prices will tend to be fairly volatile. However, the grain reserve program will be relied upon to reduce the magnitude of these fluctuations.

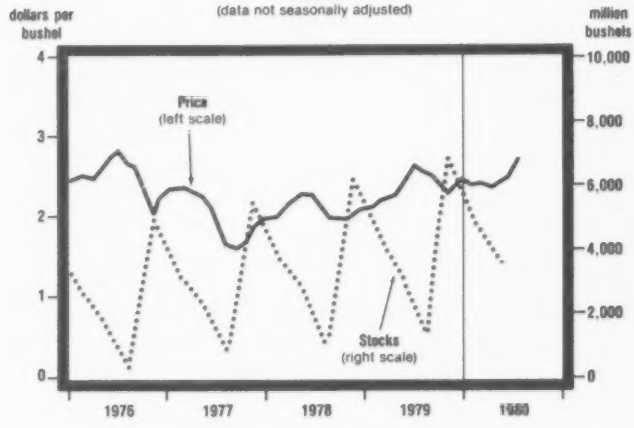
Dr. Larry J. Wipf
Assistant Vice President
Director of Regional Economics

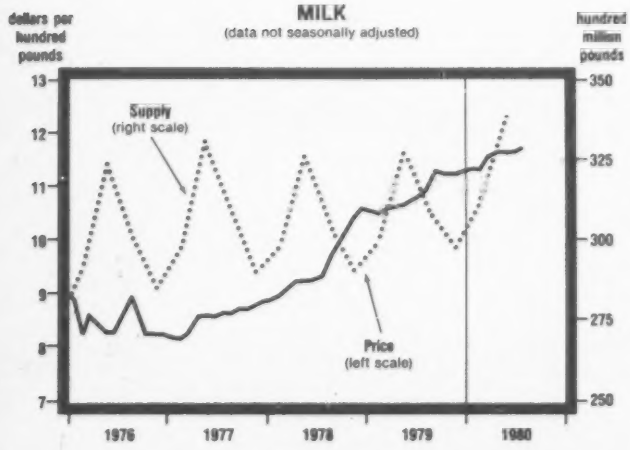
AGRICULTURAL CONDITIONS

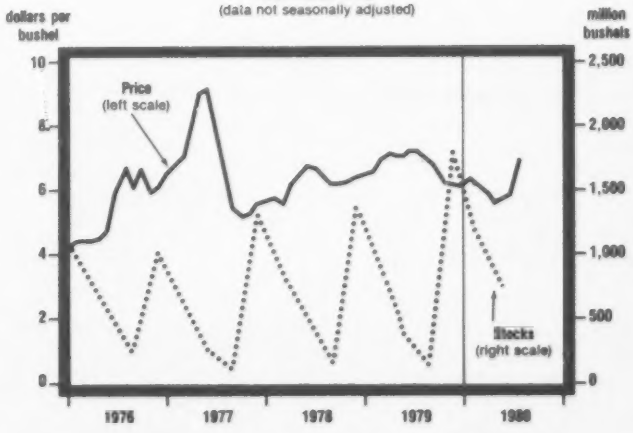












northwest economic
indicators
NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS AN AFFILIATE OF NORTHWEST BANCORPORATION

International Outlook

September 24, 1980

Highlights

- **The two-fold problem of inflation and recession is again afflicting the world economy. The end of a normal cyclical expansion combined with the recent doubling of oil prices has once again put most of the oil importing free world countries in an economic squeeze.**
- **Each of the free world's major industrial economies is weakening. The degree of weakness differs substantially between countries, however, ranging from true recession in the United States and the United Kingdom to still-enviable strength in Japan**
- **Current account balances of the Organization of Petroleum Exporting Countries (OPEC) are likely to double this year to $115 billion. A low OPEC capacity to absorb imports and high external debt levels of many oil importers could make the petrodollar recycling process difficult.**
- **The greatest relative burden of stagnating economic growth and sharp oil price increases again rests on the non-OPEC lesser developed countries. The ability of these countries to contract their economies in response to adverse world economic events is much less than that of the industrial countries.**
- **Possible economic crises in some lesser developed countries, generated by current world economic conditions, could result in disruptive political and social changes. Consequently, financial assistance to these countries during this difficult period remains necessary. The source of this assistance is of secondary importance.**

Dr. Sung Won Son
Senior Vice President and
Chief Economist

Declining rates of economic growth, debilitating inflationary pressures, volatile currency and interest rate movements, and the second round of major OPEC price hikes characterize the entry of the non-OPEC free world economy into the decade of the 1980s.

The overall economic climate confronting the world at present thus strongly resembles that which prevailed in late 1974 and 1975. Stagflation, the twin dilemma of inflation and economic stagnation, is once again afflicting the world's largest economies. Moreover, the economic health of many of the lesser developed countries is threatened by the rising cost of energy imports and the softening of economic activity in the industrial countries.

The years between 1975 and 1980 saw strong recoveries in most economies and an accommodation on the part of world financial markets to the balance-of-payments difficulties which arose in the wake of the first round of OPEC price increases. The question now is whether economic history will repeat itself. Although the similarities of the present period to 1974-75 are plain, certain important differences also exist.

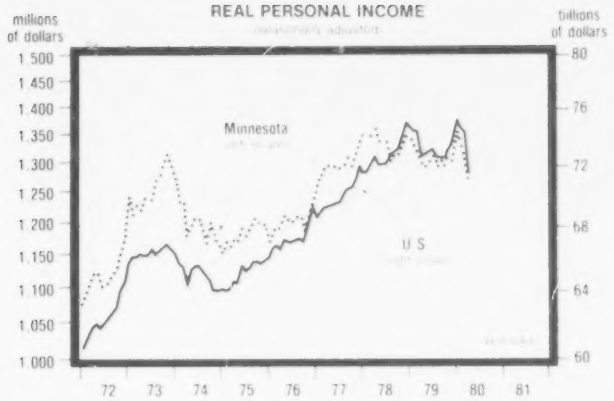
The Industrial Countries

Economic conditions and policy stances in the U.S. have been a major determinant of economic policies in most of the other member countries of the Organization for Economic Cooperation and Development (OECD) this year. Moreover, this relationship is likely to continue on into 1981.

The industrial countries of Europe and Japan have historically been very sensitive to the adverse economic effects of inflation. In addition, given the relatively high dependence of these countries on imports, the inflationary effect of a weakening of their currencies has been of particular significance to them. A weak currency also makes it more difficult for a current account deficit country to attract capital inflows to offset that deficit.

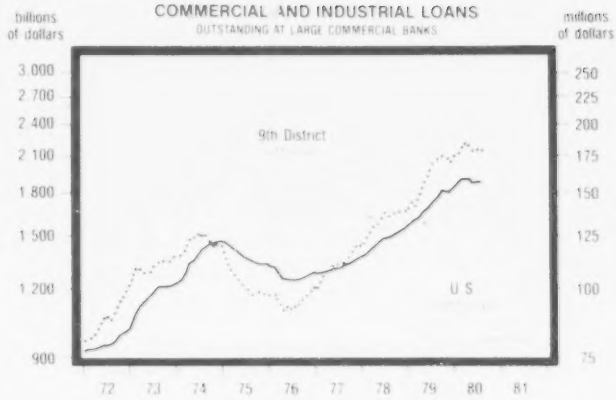
REGIONAL ECONOMIC CONDITIONS

REAL PERSONAL INCOME



COMMERCIAL AND INDUSTRIAL LOANS

OUTSTANDING AT LARGE COMMERCIAL BANKS

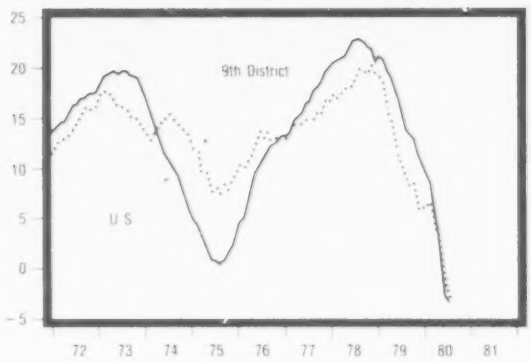


REAL RETAIL SALES

CONSUMER INSTALLMENT CREDIT

OUTSTANDING AT COMMERCIAL BANKS

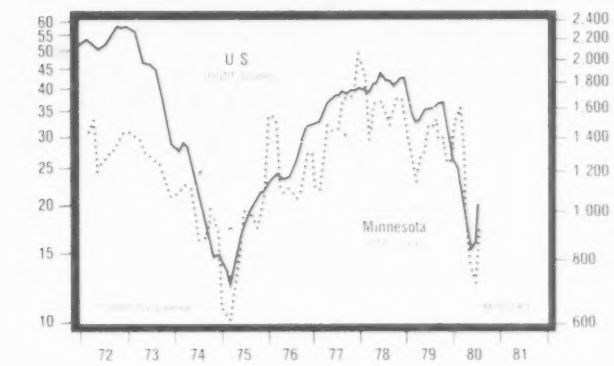
percent change from a year ago



HOUSING UNITS AUTHORIZED

HOUSING UNITS AUTHORIZED BY BUILDING PERMITS

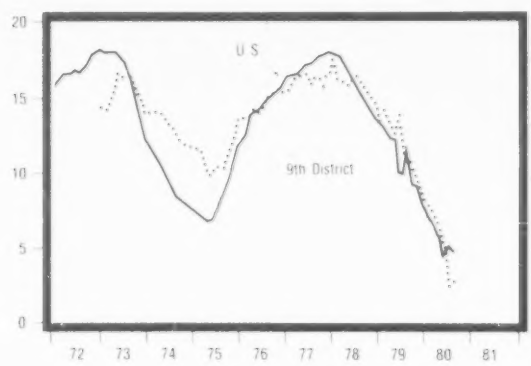
thousands of units



MORTGAGE LOANS

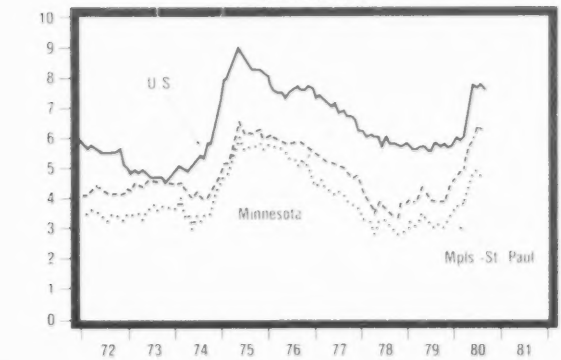
OUTSTANDING AT SAVINGS AND LOAN ASSOCIATIONS

percent change from a year ago



UNEMPLOYMENT RATES

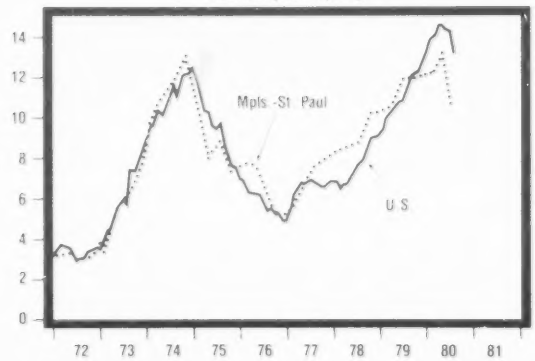
percent of labor force



CONSUMER PRICE INDEX

ALL ITEMS ALL URBAN CONSUMERS

percent change from a year ago



These relationships explain the reasoning behind the almost universal trend among the non-U.S. OECD countries this year toward restrictive monetary policies. The doubling of oil prices by OPEC at the end of last year had a highly inflationary impact on the major OECD countries. Moreover, it was necessary for these countries to take every possible action to protect the value of their currencies relative to the dollar. Since oil is priced and generally paid for in dollars, any slippage in the value of a non-dollar currency implies a magnified inflationary impact of the oil price increase for the country whose currency is weakening.

In general, Europe and Japan were hit with a one-two punch early this year — a doubling of OPEC prices in dollar terms combined with rapidly rising interest rates in the U.S. as a result of the Federal Reserve's efforts to dampen severe inflationary pressures in this country. Consequently, these countries were left with no alternative but to employ restrictive monetary policies for defensive purposes. Money and credit growth were checked and interest rates elevated despite the fact that most countries, excluding the United Kingdom, had not yet exhausted their economic expansion possibilities for the current business cycle. Inflation control took precedence over the maintenance of a strong growth path. Moreover, when U.S. interest rates dropped as sharply in the second quarter as they rose in the first, foreign interest rates remained high as the other OECD countries sought to further contain the inflationary pressures of the first quarter and to attract capital to offset seriously deteriorating current account positions.

To a large extent, inflationary pressures generated by events earlier this year have been reasonably contained in continental Europe and Japan. While the restrictive monetary policies of the first half of 1980 have indeed begun to soften economic activity in general overseas, the successful containment of inflation is now expected to lead toward more stimulative measures in Europe and Japan.

A resumption and continuation of the downward trend in interest rates

Growth of Real GNP

percent changes, seasonally adjusted annual rates

	From previous year			From previous half-year		
	1978	1979	1980	1980:I	1980:II	1981:I
Japan	6.0	5.9	5.5	6.0	3.75	3.75
Germany	3.5	4.4	2.0	2.25	-1.25	1.0
France	3.3	3.2	2.0	1.75	0.75	0.5
United Kingdom	3.5	1.7	-2.25	-2.0	-4.5	-1.0
Canada	3.4	2.9	0.25	0.25	-1.0	2.0
Total OECD	3.9	3.4	1.25	1.50	-1.0	1.0

Source: OECD

Private Consumption Price Deflator

percent changes, seasonally adjusted annual rates

	From previous year			From previous half-year		
	1978	1979	1980	1980:I	1980:II	1981:I
Japan	4.2	3.1	7.5	8.0	8.5	6.25
Germany	2.6	4.2	5.0	5.25	4.0	3.5
France	9.3	10.7	13.25	14.25	12.0	11.0
United Kingdom	8.7	12.0	18.75	18.5	18.0	14.25
Canada	7.3	9.0	9.5	9.0	10.0	10.0
Total OECD	7.2	8.5	11.25	12.0	11.0	9.5

Source: OECD

in the U.S. will allow other OECD governments and central banks to relax their restrictive stance. But, the recent backup in rates in the U.S. has undoubtedly generated substantial concern overseas. Should the upward movement in U.S. interest rates prove to be other than very temporary, expansionary measures overseas may have to be postponed. The result would be that general non-U.S. OECD growth could be even weaker through 1981 than is now expected. While this is not considered a likely scenario at present, the risk cannot be ignored.

While generalized weakness will characterize the industrial countries through 1981, recently released OECD forecasts suggest that the degrees of both weakness and inflationary pressure are likely to vary substantially between countries.

Japan's economic performance is expected to be the strongest of the OECD countries through next year. Real economic growth in the three to four percent range through next year will be largely generated through strong exports. The country's export strength is being maintained during the generalized world economic downturn because of the strong improvement in its international competitiveness. This has resulted both from favorable exchange rate movements and strong productivity increases. Inflation should peak at about 8.5 percent by the end of this year and decline moderately through 1981. The country's current account, in surplus by $16 billion as recently as 1978, will show an oil-induced deficit of more than $17 billion in 1980.

While **Germany's** real gross national product is likely to decline at a one percent annual rate in the second half of 1980, the country will still show real growth of about two percent for the year as a whole. Inflation, now running at about a five percent annual rate, should decline further through next year in line with the expected very sluggish economic recovery. Germany is likely to post a current account deficit of $16 billion this year, compared to a surplus of $8.7 billion in 1978.

France will experience generalized softness throughout its economy

through the coming year although real growth rates are expected to remain slightly positive. Inflation, running at a 14 percent annual rate in the first half of this year, should decline to the 11 percent range by mid-1981. France also has been severely affected by rising oil prices and will post a current account deficit of approximately $4 billion this year.

Very tight monetary and fiscal policies instituted by the conservative Thatcher government have led to a genuine recession in the **United Kingdom.** This recession is expected to continue through the middle of next year with the sharpest annual rate of economic decline, 4.5 percent, taking place in the second half of this year. Inflation, currently running in excess of 18 percent, is proving difficult to control due largely to labor reaction against the Government's austerity measures. The rate of price increase is likely to decelerate only to the 14 percent range during the first half of next year. Exports of North Sea oil and soft import growth are helping the country's current account balance, however. The $2.5 billion current account deficit expected this year compares favorably with the $5.2 billion deficit posted last year.

Canada, as usual, remains heavily influenced by economic activity in the United States. A one percent decline in real GNP in the latter half of this year should be followed by growth at a two percent annual rate in the first half of 1981. Inflation is expected to remain a problem, with consumer prices rising by 10 percent in the year ending next June. This is up from a nine percent increase in prices in 1979. A current account deficit of $5 billion will likely be experienced this year with some additional current account deterioration in the first half of 1981. Canada's trade position will remain adversely influenced by soft conditions in the economy of the United States, its chief trade partner.

In summary, assuming that most OECD countries can soon begin to institute some stimulative measures, this year and next year will see growth slowdowns short of actual recessions in most countries followed by sluggish recoveries. Throughout the industrial world, the inflationary pressures caused both by a five-year period of economic expansion and adjustment to the most recent transfer of real income to the oil exporting countries will make the resumption of strong, stable growth difficult to achieve. Despite the economic difficulties now confronting the industrial countries, however, the largest relative burden of adjustment to the latest round of oil price increases rests with those countries least able to afford it — the non-oil lesser developed countries.

The Lesser Developed Countries

As a result of last year's oil price increases, the aggregate current account of OPEC is expected to be in surplus by $115 billion in 1980, more than double the $55 billion surplus of 1979. This rising surplus is, of course, mirrored by corresponding increases in the current account deficits of the oil importing countries, both industrial and lesser developed. Consequently, the problem of petrodollar recycling, or getting the money from the oil suppliers to the oil users, has again surfaced with something of a vengeance.

The OPEC current account surpluses generated by the quadrupling of oil prices in 1973-74 were recycled with a minimum of difficulty. Very rapid growth in OPEC imports in the years immediately following this price rise, coupled with the willingness and ability of the international banking community to extend needed credits to oil importing countries, proved very effective in solving that recycling problem. However, despite that fact that the $115 billion surplus expected this year is not larger in inflation-adjusted terms than the 1974 surplus, the recycling problem is likely to prove harder to solve this time. This represents a very important difference between the current period and the earlier one.

Two basic reasons account for this, with the first being limits on the speed with which the members of OPEC can increase their imports in the years just ahead. The Mideast members of OPEC have very low population densities with commensurately low abilities to absorb large increases in imports. However, these countries together account for about 78 percent of the total OPEC current account surplus expected in 1980. Also, Mideast governments are very aware that the overthrow of the Shah of Iran was at least partially due to the cultural disruptions caused by the Shah's attempt to rapidly industrialize the country. Other Mideast governments will not wish to make the same mistake and, consequently, may hold down the speed with which rising oil revenues are spent on imported goods and services.

OPEC Current Account Surpluses
(billions of U.S. dollars, estimated)

	1979	1980
Saudi Arabia	$16	$41
Kuwait	14	19
Iraq	11	15
United Arab Emirates	5	8
Iran	5	3
Libya	4	14
Other OPEC (net)	0	15
Total OPEC	$55	$115

The second difficulty with the current recycling problem lies with the international banking community's realistic ability to add substantially to its loans to several oil-importing lesser developed countries. Several of the more rapidly growing LDC's are presently faced with the double difficulty of already burdensome external debt loads and additional external financing needs to support the latest round of oil price hikes. The higher risk now associated with lending to these countries is likely to preclude most international banks, who ultimately must account to both their shareholders and various regulatory authorities, from substantially increasing their positions in them.

The burden of recycling is therefore likely to be placed more heavily on governments and multilateral institutions this time around. Substantial increases in direct lending by OPEC members to those countries

most in need of additional financing is not likely to occur. The Bank of England has estimated that 56 percent of OPEC's $236 billion of investments at the end of 1979 were composed of either bank deposits or United States and United Kingdom government securities. Only 16 percent of these investments were in the form of loans to developing countries, either directly or through regional and development agencies. Recent statements on investment policy by OPEC officials strongly suggest that this financial conservatism will continue.

As in the 1974-75 period, then, many non-oil lesser developed countries are again caught in a foreign exchange squeeze. Decreasing rates of economic activity in the industrial countries have dampened demand for lesser developed countries' exports while the doubling of oil prices has substantially increased their import bills. The industrial country reaction to the latest rise in energy prices has been a reduction in the rate of economic growth. Economic forces would also dictate that the lesser developed countries follow a similar course of action. However, the ability to absorb economic cutbacks is far less in the lesser developed countries than in the industrial countries. In several lesser developed countries, forced economic crises could result in violent or otherwise adverse social and political changes. Consequently, every country and institution capable of aiding the recycling process should carefully consider the possible costs of its failure to do so.

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northwest economic indicators

NORTHWESTERN NATIONAL BANK OF MINNEAPOLIS AN AFFILIATE OF NORTHWEST BANCORPORATION

Supply Side Economics

October 24, 1980

Highlights

- **For too many years, our economic policy has focused on demand. Price increases have gained momentum. Credit crunches have become periodic occurrences. Each succeeding boom-and-bust cycle has become worse.**
- **As a nation, the United States can not afford more of the same. New and different ideas are needed. In this context, the fallout from supply side economics will be beneficial and productive to us all.**
- **The Reagan-Kemp-Roth proposal does away with the difficulty of selecting specific tax cuts for a subset of the population. It is broad and general enough so that everyone would benefit if it works. On the other hand, it makes the large and risky bet that tax cuts would increase the national output so much that the total revenue would not decline at all or even increase.**
- **The risk could be lowered if tax cuts are accompanied by a combination of non-military spending cuts and/or monetary restraint. Tightening credit conditions could cause some "crowding out" in the capital markets hurting interest sensitive industries, such as housing.**
- **Business tax cuts look most promising. Short-term cost of deficits would be eventually offset by higher output and lower cost of inflation. However, it may take five to ten years before significant benefits result and, we may not have the patience to wait that long.**
- **There is a danger that supply side policies may be called on to do too much. Although supply side proposals are appealing, we should not lose sight of the need to limit the growth of government expenditures as well if inflation is to be tamed.**

Dr. Sung Won Son
Senior Vice President and
Chief Economist

Adam Smith, the 18th Century apostle of free enterprise wrote, "high taxes, sometimes by diminishing the consumption of the taxed commodities and sometimes by encouraging smuggling, afford a smaller revenue to government than what might be drawn from more moderate taxes." Thus "supply side economics" was born.

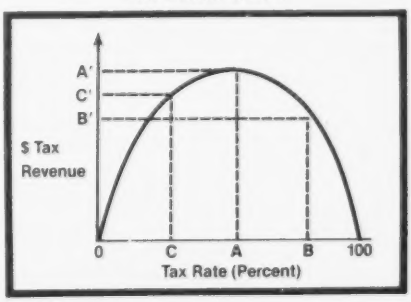
More recently, Colin Clark, the distinguished Australian economist, advanced a similar thesis in the 1940s that a tax-burden in excess of 25 percent would lead to inflation. By then, Keynesian economics with its strong demand orientation overshadowed supply side economics. Clark's advice fell on deaf ears.

A few years ago, the supply side idea was revived by Arthur Laffer, the University of California economist. According to supply side economists, inflation is caused by an excess of demand over supply. Therefore, it is better to reduce inflation by increasing supply than restraining demand. A rising tide raises all ships. In other words, everyone can have more.

The Laffer Curve

Laffer has gained a national reputation by introducing an extreme form of supply side economics, the Laffer curve. He has emphasized the disincentive effects of high marginal tax rates. Tax cuts can bring increased revenues. Laffer has many fans including Carlos Romero Barceló, the governor of Puerto Rico. So enthused was Señor Romero that he has been applying Laffer's ideas to his commonwealth's revenue policies by slashing taxes at a rate of 5 percent per year. Lo and behold, the Island's income tax collection through April of 1980 was 13.5 percent higher than the 1979 rate. Some say that the Puerto Rican experience proves Laffer's theories; others contend that the revenue increased for other reasons.

FIGURE I
The Laffer Curve



The Laffer curve is based on two key assumptions. The first important

ECONOMIC PLATFORM COMPARISONS

Carter	Reagan
TAX CUT COMPONENTS	
• Eight Percent Social Security Tax Credit • "Liberalized" Depreciation • Low-Income Tax Credits	• Three Consecutive Ten Percent cuts in Personal Tax Rates • "Accelerated" Depreciation • Tax Bracket Indexing after 1983
FEDERAL SPENDING	
• Eight billion dollars in countercyclical spending during Fiscal 1981-82 • Major items include $1 billion in unemployment benefits, $1 billion in expanded Revenue Sharing, $3 billion in aid to hard-hit industries and $1.2 billion in aid for the insulation of homes and federal buildings	• Cut Federal spending by at least two percent in each of the next three years and one percent in each of the two subsequent years. No specific cuts announced • Supports transfer of responsibility for Federal Wolfare and Education programs to the states
INFLATION	
• Supports monetary restraint • Target tax incentives to encourage investment and increase productivity • Supports voluntary wage-price guidelines • Favors review of government regulations	• Supports monetary restraint • Tax cuts will increase incentives for productive investment and thus reduce inflation • Supports massive rollbacks in regulation; specific areas not identified
UNEMPLOYMENT	
• Expand Federal job training programs • Tax relief for industries in which there is high unemployment • Proposed an Economic Revitalization Program	• Tax cuts to stimulate growth and employment • Create "urban enterprise zones" to encourage business expansion in depressed areas
ENERGY	
• Emphasize conservation • Support for alternative energy sources (syn-fuels, etc.) • Phased oil and gas price deregulation	• Solution to the energy problem is increased domestic production • Immediate and complete oil and gas price deregulation
HOUSING	
• Expand existing federal housing programs	• Reduced inflation will reduce interest rates and encourage home construction and purchase • Tax exemption for small savers
DEFENSE SPENDING	
• Continue real increases in defense spending of about three percent per year	• Sharply increased defense spending, which would grow to six percent of GNP by 1985
SOCIAL SECURITY NATIONAL HEALTH INSURANCE	
• Fund Medicare through general revenues but retaining existing funding methods for Social Security proper • Supports gradual movement towards National Health Insurance	• Opposes funding any part of Social Security through general revenues, but supports existing benefit levels and entitlement legislation • Opposes National Health Insurance

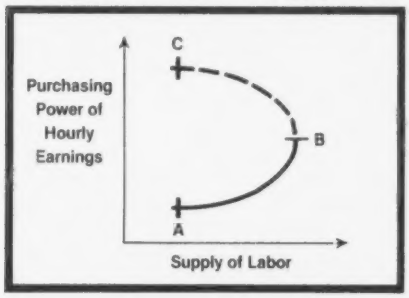
assumption is that the present tax rate is higher than optimal. In Figure I, we see a typical Laffer curve. At a zero tax rate, revenue would be nothing. On the other extreme, revenue would also be zero if earnings are taxed 100 percent. Somewhere in between the two extremes lies an optimal tax rate, A, which would maximize the tax revenue at A.

Unfortunately, according to Laffer, we are at B instead of A. That is, tax rates are too high causing work and investment to be relatively costlier, and leisure and consumption relatively cheaper than they would otherwise be. Our economy is seriously overtaxed. A big cut will unleash enormous additional economic activity, generating more than enough incremental revenue to pay for itself.

However, a goodly number of economists are skeptical about the revenue generating ability of the Laffer curve as it applies to the U.S. economy. Returning to Figure I, we could be at C. Under these circumstances, a huge tax cut would lower revenues, ballooning deficits. Deficits would probably be financed by rolling the printing press exacerbating inflation.

In order for the Laffer effect to occur, the present tax rate must be far enough to the right of the optimal rate, A, so that tax cuts would bring us back to A. If we happened to be to the left of A, like C, then the opposite of the Laffer effect would result.

FIGURE II
Backward-Bending Labor Supply Curve



The second key assumption behind the Laffer curve is that increased purchasing power through tax cuts would lead to increased supply of labor. Stimulated by additional take-home pay, people would be willing to work additional hours. In Figure II, rising purchasing power increases the supply of labor between A and B. People are eager to work more hours as buying power expands. But, the opposite relationship occurs beyond B. Economic literature tells us that people prefer leisure and work fewer hours beyond a certain point like B. Rising purchasing power of hourly earnings through a series of tax cuts might result in people working fewer hours, decreasing the supply of labor.

The implicit assumption behind the Laffer curve is that the U.S. economy is operating somewhere below B. Additional purchasing power would take us closer to B; more purchasing power means more hours-worked and tax revenues.

However, available empirical evidence shows a wide range of results. Donald Fullerton recently wrote in a paper that rising earning power draws women into the labor force, but permits males to retire earlier. The net effect of tax cuts on labor supply is small and the revenue implications are uncertain at best. A Data Resources Incorporated (DRI) model simulation has yielded similar results.

Reagan-Kemp-Roth

Herbert Stein, a respected economist and a former Chairman of the Council of Economic Advisers, has said, "nothing is easier than to find reasons for cutting taxes." The sorry state of the U.S. economy coupled with the election has attracted the attention of many politicians, including Governor Reagan, Congressman Kemp and Senator Roth.

The attention-getting tax cut proposal has become the centerpiece of Reagan's economic policy. Reagan would cut personal tax rates 30 percent over three years (the 10 percent right away is just a downpayment) and then index the tax system to eliminate future inflation-induced increases in effective tax rates.

Most everyone agrees that the Federal tax burden is too great. True enough, it is high. What about the resulting Federal deficit? If one believes in the Laffer curve and his assumptions, tax cuts would increase the national output so much that the total revenue would not decline at all or even increase.

TABLE I

REAGAN-KEMP-ROTH TAX CUT

Changes	1981	1982	1983	1984
Federal Deficit ($ bil.)	-25	-53	-97	-118
Unemployment Rate (%)	-0.5	-1.1	-1.3	-0.8
Inflation Rate (%)	0.1	0.5	1.2	1.8

Table I shows a DRI model simulation of the Reagan-Kemp-Roth Tax Cut. Federal deficits grow to $118 billion by 1984. At least in this particular exercise, the Laffer curve failed us. There are some supply effects, to be sure. The unemployment rate declines as labor supply, productivity and total output increase. However, the increased purchasing power created by the tax cuts increases demand and worsens inflation. By the end of Reagan's first term in office, the inflation rate is raised by as much as two percent.

If inflation is considered to be the nation's number one problem, the overall picture painted by the simulation is not an attractive one. However, there have been other proposals which would make the tax cut proposal workable.

One such proposal is to couple tax cuts with reductions in non-military spending. In this program, incremental deficits would be modest and the job and inflation picture would improve. Unfortunately, this is easier said than done. We have enacted many Federal "entitlement" programs indexed to inflation. The growth of these programs has been reflected in the rising share of payments for individuals and also of grants to state and local governments. Above all, it is prudent to remember that politicians who get specific about spending cuts make more enemies than friends.

Another proposal is to combine non-military spending cuts with monetary restraint. As non-military spending cuts are less than tax cuts, deficits would increase. Monetary restraint would allow the financing of the Federal deficit by crowding out private borrowers. Interest rates would be bid up. Credit sensitive industries, such as housing, would be worse off. Nevertheless, total output would increase creating jobs and the price picture would improve.

Offsetting spending cuts and monetary restraints are not the only alter-

ECONOMIC OUTLOOK

October 1980

Improving Price Trend

	Level			Percent Change from the Previous Quarter (annual rates)								Annual Percent Change**		
	1979	1980E	1981E	1980E				1981E				1979	1980E	1981E
				I	II	IIIE	IVE	IE	IIE	IIIE	IVE			
Consumer Price Index (1967 = 100)	217.6	247.0	270.7	16.9	13.7	8.5	10.7	9.2	9.1	8.8	9.6	11.3(12.8)	13.5(12.4)	9.6(9.2)
Food	234.9	254.9	284.5	6.0	6.4	13.5	16.0	11.2	10.5	10.0	9.0	10.9(10.0)	8.5(10.4)	11.6(10.2)
Nonfood Commodities	195.0	221.7	239.6	20.5	9.4	8.0	7.7	7.2	8.6	8.0	10.0	11.7(13.9)	13.7(11.3)	8.1(8.5)
Services	234.4	269.9	296.2	18.6	21.7	4.0	11.0	10.0	9.0	9.0	9.5	11.0(12.8)	15.2(13.6)	9.7(9.4)
Producer Price Index, Finished Goods (1967 = 100)	216.1	245.9	273.0	17.6	10.3	15.0	11.0	9.2	11.2	11.0	11.1	11.0(12.6)	13.8(13.4)	11.0(10.6)
Compensation Per Manhour, Nonfarm Private (1967 = 100)	247.6	271.7	299.5	10.9	10.8	8.5	10.0	11.0	10.5	10.0	10.0	8.8(9.0)	9.7(10.1)	10.2(10.3)
Labor Productivity, Nonfarm Private (1967 = 100)	115.5	114.5	115.1	– 1.0	– 2.8	0.4	2.0	– 1.0	1.5	1.0	2.0	– 1.3(– 2.0)	– 0.9(– 0.3)	0.5(0.9)
Unit Labor Costs, Nonfarm Private (1967 = 100)	214.3	237.4	260.4	12.1	14.0	8.1	8.0	12.0	9.0	9.0	8.0	10.2(11.3)	10.8(10.5)	9.7(9.5)
Corporate Profits After Taxes, bil. $	144.1	139.5	137.7	33.8	– 58.1	40.0	– 10.0	– 12.6	10.0	25.0	15.0	18.6(11.0)	– 3.2(– 8.3)	– 1.3(8.4)
Disposable Personal Income, bil. $ (1)	1624.2	1784.3	1965.5	13.5	4.3	10.5	10.0	10.0	10.0	12.0	13.0	11.4(10.4)	9.9(9.5)	10.2(11.2)
Real Disposable Personal Income, bil. $ (2)	746.4	722.4	726.1	– 2.9	– 8.2	1.7	– 0.6	0.7	0.8	2.9	3.2	0.1(– 2.1)	– 3.2(– 2.5)	0.5(1.9)
New Passenger Car Sales (millions of units)	10.7	9.1	9.4	10.7*	7.7*	8.9*	9.0*	8.7*	9.2*	9.5*	10.0*	10.7*	9.1*	9.4*
New Private Housing Starts (millions of units)	1.7	1.3	1.6	1.3*	1.1*	1.3*	1.4*	1.2*	1.6*	1.7*	1.8*	1.7*	1.3*	1.6*
Unemployment Rate, %	5.8	7.3	8.5	6.1*	7.5*	7.6*	8.0*	8.5*	9.0*	8.3*	8.0*	5.8*	7.3*	8.5*
Federal Government Deficit, bil. $	11.4	51.8	61.3	22.9*	49.2*	65.0*	70.0*	80.0*	70.0*	50.0*	45.0*	11.4*	51.8*	61.3*

E—Estimated.

(1) Take-home pay.

(2) Disposable personal income divided by the CPI.

*All figures are expressed as annual rates, not percent changes.

**Numbers in parentheses are 4th quarter-to-4th quarter percent changes.

ECONOMIC OUTLOOK (Without Inflation)

October 1980

Double Dip Recession—Sluggish Recovery

	Level (billions of 1972 $)			Percent Change from the Previous Quarter (annual rates)								Annual Percent Change**		
	1979	1980E	1981E	1980E I	1980E II	1980E IIIE	1980E IVE	1981E IE	1981E IIE	1981E IIIE	1981E IVE	1979	1980E	1981E
Gross National Product	1431.6	1420.1	1429.0	1.2	−9.6	0.4	2.0	−3.6	5.4	3.9	4.5	2.3(1.0)	−0.8(−1.6)	0.6(2.5)
Consumer Expenditures	924.5	925.4	940.1	0.5	−10.5	6.2	2.1	0.3	1.9	3.6	4.2	2.6(1.6)	0.1(−0.6)	1.6(2.5)
Durables	147.2	135.9	138.3	−3.5	−41.1	25.0	4.0	−5.2	6.0	10.5	10.3	0.3(−3.6)	−7.7(−7.3)	1.8(5.2)
Nondurables	349.1	350.6	354.5	−1.1	−6.9	2.0	1.5	1.0	1.0	3.0	4.0	1.7(0.9)	0.4(−1.2)	1.1(2.3)
Services	428.3	438.9	447.3	3.2	−1.3	4.5	2.0	1.5	1.5	2.0	2.5	4.3(4.2)	2.5(2.1)	1.9(1.9)
Investment	215.2	187.6	180.9	−8.4	−25.8	−21.0	7.2	−27.1	36.5	10.3	12.2	0.4(−4.5)	−12.8(−12.9)	−3.6(5.4)
Fixed Residential (1)	56.7	44.0	45.0	−26.3	−61.6	6.0	12.0	−10.0	22.1	25.1	30.6	−5.7(−7.0)	−22.3(−23.8)	2.2(15.8)
Fixed Nonresidential (2)	148.8	144.6	135.3	1.9	−14.7	−10.1	−3.0	−15.1	0.3	0.8	3.4	6.2(3.4)	−2.8(−6.7)	−6.4(−2.9)
Structures	48.1	48.8	44.9	1.6	−9.2	−7.0	−4.8	−15.2	−6.7	−3.4	−2.1	9.6(7.7)	1.4(−5.0)	−8.1(−6.9)
Producers Durable Equipment	100.7	95.8	90.4	2.0	−17.0	−12.0	−2.0	−15.0	4.0	3.0	6.2	4.6(1.5)	−4.8(−7.6)	−5.6(−0.9)
Change in Inventories	9.7	−1.0	0.6	0.3*	2.6*	−5.0*	−2.0*	−9.0*	2.3*	4.0*	5.1*	9.7*	−1.0*	0.6*
Net Exports (3)	17.6	27.4	28.0	25.0*	28.4*	28.0*	28.0*	28.0*	28.0*	28.0*	28.0*	17.6*	27.4*	28.0*
Exports	119.9	128.0	128.3	131.7*	128.3*	126.0*	126.0*	126.0*	128.0*	129.0*	130.0*	119.9*	128.0*	128.3*
Imports	102.3	100.7	100.3	106.7*	99.9*	98.0*	98.0*	98.0*	100.0*	101.0*	102.0*	102.3*	100.7*	100.3*
Government Purchases	274.3	279.8	279.9	4.3	1.3	−1.7	−1.4	0.1	0.9	1.4	1.2	0.4(0.4)	2.0(0.6)	0.0(0.9)
Federal	99.4	105.7	107.2	13.3	9.5	−2.5	−1.3	2.0	3.0	2.0	1.4	0.9(1.8)	6.3(4.5)	1.4(2.1)
State and Local	174.9	174.2	172.8	−0.7	−3.1	−1.5	−1.5	−1.0	−0.3	1.0	1.1	0.2(−0.3)	−0.4(−1.7)	−0.8(0.2)

E—Estimated

(1) Includes consumer purchases of homes and landlord's purchases of durable goods.

(2) Is roughly equivalent to capital spending.

(3) Exports less imports.

*All figures are dollars, not percent changes.

**Numbers in parentheses are 4th quarter-to-4th quarter percent changes.

natives. The Reagan-Kemp-Roth tax cuts could be matched by increases in other taxes, such as a new gasoline tax. Proponents of the proposal argue that such a scheme would cut waste, like unnecessary gasoline consumption, without materially harming economic activity. The additional tax would result in a one-time increase in the Consumer Price Index. However, the combination of tax cuts and increases would eventually have desirable effects on inflation and jobs.

Business Tax Cuts

A tax cut is justified if long-term benefits from the cut outweigh short-term costs. A good example is business tax cuts designed to spur lagging investments in plant and equipment and raise productivity. Short-run costs in terms of deficits and inflation would be more than offset by favorable economic outcomes.

There are a couple of such interesting proposals receiving attention. The first one is the Jones-Conable "Capital Cost Recovery Act." Tax lives would become ten years for structures, three years for cars and light trucks and five years for other equipment (10-5-3). The second proposal has a more moderate change in depreciation for equipment, and an increase in the investment tax credit (ITC). A combination of a reduction in corporate tax rates, and liberalized depreciation and investment tax credits would be another obvious alternative.

TABLE II

BUSINESS TAX CUT (By 1985)

Changes	Corporate Tax Rate	Investment Tax Credit	Depreciation
Inflation (%)	-0.2	-0.2	-0.2
Potential GNP (%)	0.2	0.6	0.7

A DRI model simulation as shown in Table II above, analyzes the expected outcomes. By 1985, the inflation rate abates somewhat and the job outlook improves. Since investments take a long lead time to plan and execute, large payoffs from business tax cuts are likely to show up later in the decade.

There are other problems associated with business tax cuts. Our political process may not have the necessary patience built into it, especially if costs have to be paid now. The "10-5-3" approach would be very costly and favors only those businesses with large fixed investments. A corporate income tax cut to benefit those businesses without a lot of brick and mortar might be more saleable. Increases in the investment tax credit would also breathe fresh air into capital spending. The problem is that a struggling firm without much income might not be able to take advantage of it. Perhaps, the ITC can be structured in such a way that a firm purchasing plant and equipment can receive direct rebates from the Federal government regardless of income.

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